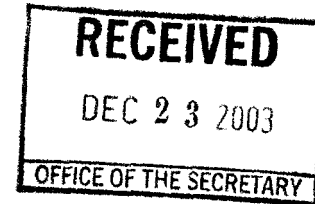


December 20, 2003

406  
413 Hayden Hall  
Northeastern University  
Boston, MA 02115

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 5<sup>th</sup> St. NW  
Washington, D.C. 20549-0609



Dear Mr. Katz:

Re: File No. S7-19-03

I would like to comment on the SEC's proposal to require companies to include security holder nominees for election as director. I would also like to offer a suggestion for the SEC to consider to mitigate the concerns I see with the proposal.

### **The proposal is contrary to clearly stated concerns of Congress**

This proposal will give financial institutions (such as pension funds and mutual funds) increased freedom to directly influence corporate decisions; in fact, that is the intent of the proposal. The proposal is thereby facilitating a shift in power that Congress, as early as 1913 in the Pujo hearings<sup>1</sup> and as recently as 1980<sup>2</sup> has specifically cautioned against.<sup>3</sup> Congressional concern over growing institutional investors' power to influence corporations could not be more explicit. As stated in the 1980 Senate Report,<sup>4</sup>

In 1968, Congress directed the SEC to conduct a study of institutional investors and their impact on the securities markets, the interests of issuers of securities and the public interest in general. **Congress was concerned that the tremendous growth in securities held and traded by the larger banks, insurance companies, pension funds, and investment advisors might result in a concentration of economic power by a few institutional traders not only over the auction markets, but over the management's of the companies whose stock they held, and indeed over American industry, itself.** (my emphasis)

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<sup>1</sup> The Pujo Committee is the common name attached to "Investigation of Concentration of Control of Money and Credit." House Committee on Banking and Currency. H. Rept. No. 1593, 62<sup>nd</sup> Congress. 3<sup>rd</sup> Session, Feb. 28, 1913.

<sup>2</sup> "Structure of Corporate Concentration: Institutional Shareholders and Interlocking Directorates among Major U.S. Corporations." Committee on Governmental Affairs, United States Senate. December 1980.

<sup>3</sup> I have attached for your reference a partial bibliography of other government reports and publications concerned with financial institutions' influence on corporations.

<sup>4</sup> "Structure of Corporate Concentration: Institutional Shareholders and Interlocking ...." page 2.

The basis of my concerns is that although institutions are major stockholders in most major corporations their perspective and interests can be distinctly different from that of managements of the companies and, more important, different from the smaller non-institutional owners of the company's stock. The following quote from a prominent legal scholar illustrates this point. He states:'

The bankruptcy of an airline company, for example, might be a disaster for its employees and managers who lose their jobs but a matter of indifference to its investors who own shares in other airline companies that obtain the bankrupt company's routes.

While the author's point is a valid one from the perspective of the diversified investor, it may not be the appropriate perspective for a company's management, undiversified shareholders, or for public policy. And, while I realize that the current proposal is different, the point is exactly the same: those sponsoring director nominees, and largely controlling the outcome of the vote (diversified funds), might not, ironically, have the best interests of the company in mind and may not suffer any significant consequence if their actions cause harm to the company. In fact, they could benefit by certain actions if their holdings in competitive companies are larger than those in the subject company.

Even Adolf Berle, probably the most widely cited scholar on the public corporation, whose work helped create the SEC, voiced concern about the rising influence of institutional investors. Although best known for his 1932 "The Modern Corporation and Private Property," Berle, in 1968 said,'

In recent years, stock has become more concentrated in the hands of institutional investors... such a concentration of power is a very dangerous thing .... I recall no period in American history when power over business was concentrated in financial circles that did not result in trouble. The Panic of 1907 and the crash of 1929 are good examples.

## **Suggested Amendment**

If the SEC is going to allow shareholder nominees I would like to suggest that it also consider ways to link shareholder responsibility to their actions.. One way to accomplish this would be to expand the "Proposed eligibility standards" in section 5. a. of the current proposal. While I agree with the current proposal's 5% ownership threshold, I think it should also include the following:

*A security holder or group of security holders must certify that **they** are not significant owners of the stock of any competitor of the subject company.*

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<sup>1</sup> Fischel, Daniel. "The Business Judgment Rule and the Trans Union Case." Institute on Dynamics of Corporate Control." Business Lawyer Vol 40 August 1985, pg 1442

<sup>2</sup> Berle, Adolf, "The New Realities of Corporate Power." Dun's Review, December 1968 43-45, 40

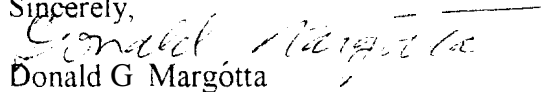
This might be defined as owning more than 1% of any other company at the 3 digit SIC code level (or other industry classification)

Without such an amendment subject companies could be faced with having director nominees who may be nominated, and voted on, by the largest owners of their major competitors, exactly the type of outcome the Senate report quoted earlier warned against

Finally, I am thoroughly familiar with the counter-arguments in favor of having institutional investors become more involved in their portfolio companies. While I disagree with many of those arguments, I believe the suggestion offered here would allow greater involvement while insuring that such involvement is for the benefit of the corporation and all its shareholders.

I have enclosed a short article that describes some of my concerns in more detail and I would be happy to discuss these with you. And, for your reference, all of my research and most of my teaching for the last 20 years has focused on corporate governance issues, an interest which started with my Ph.D. thesis on the influence of institutional investors on the corporation. I have also testified on corporate governance issues at the SEC, and to various Senate and House groups, several state legislatures, and in approximately 15 corporate governance related court cases.

Sincerely,



Donald G Margotta

Associate Professor of Finance

Northeastern University

617-373-4739

## **Partial Bibliography of Government Publications and Reports Related to Control of U.S. Corporations by Financial Institutions**

"Structure Of Corporate Concentration. Institutional Shareholders and Interlocking Directorates Among Major U.S. Corporation, A Staff Study, Committee On Governmental Affairs United States Senate, 96<sup>th</sup> Congress, 2d Session, 1980

Voting Rights in Major Corporations (Sen. Doc. 95-99, June 1978) and Interlocking Directorates Among the Major U.S. Corporations (Sen. Doc. 95-107, June 1978)

Staff studies, Senate Committee on Governmental Affairs, Subcommittee on Reports, Acct'g and Mgmt, Sen. Doc, 95-99 and Sen., Doc. 95-107, 95<sup>th</sup> Cong., 1<sup>st</sup> sess., 1978

Institutional Investors Common Stock (Sen. Doc. 94-247, May 1975)

"Corporate Ownership and Control," Senate Committee on Government Operations, Subcommittee on Reports, Accounting and Management. November 1975, Sen. Doc. 94-246, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. Public Law 94-29, 1975.

Disclosure of Corporate Ownership (Sen. Doc. 93-62, March 1974)

Hearings, "Corporate Disclosures," Senate Committee on Government Operations, Subcommittee on Intergovernmental Relations and Subcommittee on Budgeting, Management and Expenditures, Parts 1, 2, and 3, 1974:

"Institutional Investor Study Report " Securities and Exchange Commission, 1971 House Doc , 92-64 92<sup>nd</sup> Cong , 1<sup>st</sup> Session 1971

"Commercial Banks and Their Trust Activities Emerging Influence on the American Economy." Subcomm Print, House Committee on Banking and Currency, 90<sup>th</sup> Cong, 2d Sess , July 8, 1968 (Patman Subcommittee Study).

House Rept. No. 1665, House Interstate and Foreign Policy Committee, 90<sup>th</sup> Cong., 2<sup>nd</sup> Sess., July 1968, P. 2804. Public Law No. 90-438 (July 29, 1968).

Temporary National Economic Committee (TNEC), "Investigation of Concentration of Economic Power." The Distribution of Ownership in the Largest Non- financial Corporations (Monograph 29), S. Doc. No. 35, 77<sup>th</sup> Cong., 1<sup>st</sup> Sess. The T.N.E.C was created by a joint resolution of Congress on June 16, 1938. "Many of the investment problems of nation arise out of the concentration of investment funds and their control in few hands." (Page 91)

"Investigation of Concentration of Control of Money and Credit." House Committee on Banking and Currency. H. Rept. No. 1593, 62<sup>nd</sup> Cong. 3d Sess. Feb. 28, 1913.

# Opinion

## Large financial institutions: Are they investors or owners?

**DONALD G. MARGOTTA**

**F**INANCIAL INSTITUTIONS OWN MORE than 45 percent of the stock of the New York Stock Exchange and account for at least 70 percent of trading volume. They are the most important investors in the market today. In many ways, they are ideal investors. But the same characteristics that make them ideal investors in corporate securities may make them less than ideal owners of corporations.

Large financial institutions have an advantage as investors primarily because of their size. Pension funds alone control more than \$1.5 trillion in assets. They utilize the latest investment and trading technologies from Wall Street and the academic finance community. Index arbitrage, portfolio insurance, dividend captures, options and futures trading strategies are profitable only for investors large enough to afford them.

Even more important, institutions hold highly diversified portfolios. They not only own shares and bonds of many corporations, they also have the expertise to diversify into foreign securities and other, more specialized, assets such as real estate, venture capital projects and leveraged buyout funds.

This diversifying is exactly what institutions should do, from a standpoint of ordinary prudence. Modern finance theory shows that highly diversified portfolios are the most efficient. They provide the optimum balance between risk and potential return.

Now, however, some institutions are attempting to expand from passive, efficient, corporate investor to active corporate owner. For example, the California Public Employees Retirement System and the New York State and Local Retirement System requested a role in selecting the next chairman at General Motors Corp. and in reviewing certain policies at GM.

In the contentious area of corporate governance, institutions spearheaded drives last year in 19 corporations to rescind or put to a vote shareholder "poison pill" plans. They led the drive to have several companies opt out of state takeover laws.

This institutional activism raises issues unlike any faced by American corporations. Some observers view it as long overdue and feel it will contribute needed oversight for company managers and directors and lead to greater efficiency and responsiveness to shareholder concerns. There is a significant down side to this expanded role, however, that could have unintended adverse side effects on the competitiveness of American corporations.

One of the most remarkable unintended consequences is that the interests of these largest owners of corporate stock may no longer coincide with

those of the corporations whose stock they own. This unusual situation arises as a direct result of the key characteristic of diversified portfolios: That they eliminate virtually all of the business risk inherent in being an "owner" of a corporation.

In the language of finance theory, diversifiable (nonsystematic) risk is eliminated, leaving only nondiversifiable (systematic) risk to be borne by the investor. The nondiversifiable risks borne by diversified investors are those that are largely uncontrollable; world-wide depressions and natural disasters are examples.

But the diversifiable risks that are eliminated are exactly those business risks that drive entrepreneurial and competitive activity. If major owners of corporate stock are denied the motivational heat from the fires of business risk and competition, what is left to spark competitiveness?

For example, bankruptcy is usually a disaster for any group whose responsibilities or fortunes are linked to the corporation. These include creditors, workers, suppliers, directors, managers, communities and undiversified stockholders — but not diversified stockholders.

Bankruptcy is a diversifiable risk and, to paraphrase a well-known scholar, a matter of indifference to diversified stockholders. Therefore, while those with responsibilities and futures linked to the corporation have incentives to compete and adopt corporate policies to avoid bankruptcy, the diversified owner might well feel no pressure to do so, and some inclination to resist certain policies aimed at avoiding bankruptcy.

It is not surprising that a market dominated by investors largely insulated from the adverse effects of bankruptcy will value highly leveraged companies and penalize companies more conservatively financed.

For 50 years, scholars have called for management interests to become more closely aligned with stockholder interests. While this is clearly desirable, the time may be at hand when stockholders who desire to affect the internal affairs of the corporation demonstrate that their interests are aligned with the corporation's.

Such alignment might be demonstrated by holding stock of competing corporations. However, if institutional investors choose to become more traditional owners, with their fortunes tied to specific corporations, they may become, at least from the perspective of modern finance theory, less efficient investors.

*Donald G. Margotta is assistant professor of finance at Northeastern University in Boston, where he conducts research in corporate governance issues.*